



TAX FACTS

From the
State of Hawaii, Department of Taxation

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CONTRACTORS AND THE GENERAL EXCISE AND USE TAXES

99-3

Persons doing business in Hawaii are required to register for and pay the state's general excise tax. The general excise tax is a tax imposed on businesses for the privilege of doing business in Hawaii, and is assessed at various percentage rates on the gross income businesses derive from activity in the State. Businesses also may need to pay Hawaii's use tax on the value of tangible personal property which is brought into Hawaii from anywhere outside Hawaii.

Contractors engaged in the construction business are subject to the general excise and use taxes. This issue of Tax Facts supersedes Tax Facts 97-1, issued February 1997, answers basic questions about how these taxes apply to construction contractors, and addresses the changes in the laws passed by the 1999 Legislature.

1. Who is a contractor?

For purposes of the general excise tax, a contractor is a person who contracts to erect, construct, repair, or improve buildings, highways, and other structures and includes those engaged in the practice of architecture, professional engineering, land surveying, landscape architecture, and pest control or fumigation.

"Other structures" means projects involving property that is on or attached to land or other real property, and therefore, does not include ships.

2. Are out-of-State contractors with no permanent office or other presence in Hawaii subject to Hawaii's general excise tax if they work on projects located in Hawaii?

The general excise tax taxes persons for the privilege of doing business in Hawaii. Therefore, out-of-State contractors will be subject to this tax if any work is performed by them in Hawaii.

3. Must Hawaii contractors pay the general excise tax on gross income from a construction project which is located outside of Hawaii?

Hawaii contractors do not need to pay the general excise tax on gross income derived from activity outside Hawaii. However, if the work for an out-of-State project actually is performed in Hawaii (e.g., architectural work done in Hawaii for a hotel being built on Guam), then the gross income from the work performed in Hawaii will be subject to the general excise tax. However, after December 31, 1999, contracting work performed in Hawaii for an out-of-State project is not subject to the general excise tax, per Act 70, Session Laws of Hawaii (SLH) 1999.

4. Must contractors doing business within and without Hawaii report the gross income from a construction project located in Hawaii but for which part of the work was performed outside Hawaii?

The total income is subject to the general excise tax because the "place of performance" is presumed to be where the real property to which the contracting activity relates is located.

5. Should contractors report their income under "contracting" or "services, including professional services", on their general excise tax returns?

Contractors, including those engaged in architecture, professional engineering, land surveying, landscape architecture, and pest control or fumigation, should report the income they receive as a result of contracting activity under "contracting", not as "services, including professional services". Certain taxpayers, such as architects or engineers, may be engaged as both contractors and service providers, depending on the work performed. A contractor is defined in the response to question #1 above. Thus, an architect or engineer is engaged in business as a contractor when managing or designing a construction project but engaged as a service provider when performing a feasibility study not related to construction work.

6. What is the general excise tax rate on contracting income?

Gross income from contracting activity is subject to the general excise tax at the rate of 4%.

7. Are contractors taxed on their gross income or only on their net profit?

Contractors are subject to the general excise tax on their gross income, not on their net profit. However, certain amounts may be deductible.

8. Can contractors deduct the cost of materials "used" for the project?

No. The cost of materials cannot be deducted from gross income subject to the general excise tax.

9. Are payments to subcontractors deductible on the general excise return?

Yes. Payments to subcontractors and/or specialty contractors may be deducted from gross income subject to the general excise tax, provided certain conditions are met.

First, both the contractor claiming the deduction and the subcontractor and/or specialty contractor must have a general excise tax license.

Second, the name and general excise number of the subcontractor and/or specialty contractor and the amounts paid must be listed on the general excise tax return of the contractor claiming the deduction. (Prior to July 14, 1998, the subcontractor and/or specialty contractor must have actually paid the general excise tax due on the amount claimed as a deduction. Act 169, Session Laws of Hawaii 1998, amended the law relating to the subcontract deduction by relieving the contractor of the liability for the general excise taxes on the contract amounts paid by the contractor to the subcontractor and/or specialty contractor). See Department of Taxation Announcement No. 98-16 for more information.

Third, the subcontractor or specialty contractor must meet one of the following three criteria:

1. Is a contractor, as defined in section 237-6, Hawaii Revised Statutes (HRS); or
2. Is a specialty contractor, duly licensed by the Department of Commerce and Consumer Affairs (DCCA) under section 444-9, HRS; or
3. Is a specialty contractor who is not licensed by the DCCA under section 444-9, HRS, but who performs contracting activities exclusively on federal military installations in the State.

This deduction is commonly called, "the subcontract deduction". See Department of Taxation Announcement No. 99-25 for more information.

EXAMPLE - ABC Construction Company, a contractor licensed under Chapter 237, HRS, is the prime contractor for the construction of a commercial building. ABC subcontracts with DEF Company to install the plumbing system. DEF is not licensed as a specialty contractor under Chapter 444, HRS. Section 237-13(3)(B), HRS, allows a prime contractor a deduction for payments to (1) subcontractor and/or (2) specialty contractors licensed under Chapter 444, HRS. Although DEF is not licensed as a specialty contractor, DEF is a subcontractor doing work as defined in Chapter 237-6, HRS. Therefore, ABC is entitled to a deduction for payments to DEF provided that DEF meets the other requirements to be claimed as a subcontractor.

10. Can the subcontract deduction be claimed if the subcontractor merely sells building materials, supplies, and other tangible personal property to the contractor?

No. The subcontractor must be acting as a contractor, as opposed to merely selling construction materials and supplies to the contractor.

EXAMPLE - ABC Supply House, a specialty contractor licensed with the DCCA, sells customized cabinets to Gravel Construction Company, which Gravel Construction Company installs for its customers. In this instance, ABC Supply House is acting as a seller of tangible personal property, not as a contractor, and will report this income under "wholesaling" which is taxed at the rate of 0.5%. Therefore, Gravel Construction Company may NOT claim the subcontract deduction for payments to ABC Supply House.

EXAMPLE - ABC Supply House also sells and installs cabinets for OK Construction Company, a general contractor. Because ABC Supply House installs the cabinets in this instance, ABC Supply House is acting as a contractor and will

report this income under "contracting". Therefore, OK Construction Company may claim the subcontract deduction with respect to amounts paid to ABC Supply House.

11. Are sales to a contractor of construction materials and other supplies considered wholesale transactions taxed at the rate of 0.5%, or retail transactions taxed at the rate of 4%?

Sales of materials that are incorporated by the contractor into the finished work and which remain perceptible to the senses are considered wholesale transactions taxed at the rate of 0.5%. All other sales, such as sales of equipment, are retail transactions taxed at the rate of 4%.

12. On some projects, a prime contractor contracts with subcontractors who may, in turn, contract with another subcontractor. Is only the prime contractor eligible for the subcontract deduction, or is a subcontractor who contracts with another subcontractor also eligible to claim this deduction?

Both a prime contractor and a subcontractor may claim the subcontract deduction provided all the requirements, as stated in question #9 above, are met.

13. What relief is provided to contractors under Act 71, Sessions Laws of Hawaii (SLH) 1999, which reduces the effect of the pyramiding of the general excise tax?

Currently, services rendered to contractors to assist the latter in executing a contract is taxed at the rate of four percent. The Act, effective January 1, 2000, provides for an annual decrease of 0.5% in the tax rate effective calendar year 2000 until it reaches the 0.5% rate in calendar year 2006 for certain services. The 0.5% rate will apply thereafter.

14. What type of services will be taxable at the new rate?

Services, but not contracting work, rendered upon the order or request of a licensed contractor for the purposes of assisting the licensed contractor in executing a contract, are covered. However, services that constitute "overhead" will not be allowed the new rate.

15. What constitutes "overhead" which is not taxable at the new rate?

"Overhead" means continuous or general costs occurring in the normal course of a business, including but not limited to costs for labor, rent, taxes, royalties, interest, discounts paid, insurance, lighting, heating, cooling, accounting, legal fees, equipment and facilities, telephone systems, depreciation and amortization.

16. If a contractor pays its subcontractors more than the contract amount for a particular job, can the contractor deduct everything it paid to its subcontractors?

No. For each contract, a contractor may deduct no more than the total gross income which would be taxable were it not for the subcontract deductions. In other words, the deductions claimed for a particular contract cannot exceed the contract amount.

EXAMPLE - Charlie Construction Company has a contract to construct a building in Hawaii for \$500,000. Charlie Construction Company subcontracts the plumbing work to Drain, Inc., for \$150,000; the electrical work to Gray & Associates for \$200,000, and the roofing work to Steeple, Ltd.,

for \$200,000; for a total of \$550,000. In this situation, Charlie Construction Company will report \$500,000 as contracting income, so the maximum subcontract deduction which Charlie Construction Company may claim also is \$500,000. Charlie Construction Company may not use the \$50,000 of subcontractor payments which exceeds its income from this project to offset its income from other contracting jobs.

17. Is contracting work performed for the county, state or federal governments subject to the general excise tax?

Yes. Contracting activity with any government entity, including activity performed on government properties such as military bases, is subject to the general excise tax.

An exemption is provided, however, for contracting activity performed under certain scientific contracts with the federal government. This exemption does not apply to scientific projects which are merely funded by the federal government (e.g., research conducted at a college or university which is funded by a federal research grant).

18. Are there any other general excise tax exemptions specifically for contractors?

Yes. An exemption from the general excise tax is provided for gross income derived from the planning, design, financing, construction, sale, or lease for certified or approved low- and moderate-income housing projects in Hawaii.

To qualify for this exemption, the general contractor must complete a Form G-37, General Excise Tax Exemption For Certified or Approved Housing Projects, for each contractor, supplier, etc., connected with the project, and submit the forms to the State Housing Finance and Development Corporation, or, if a county project, to the appropriate county housing authority for approval. A copy of the approved Forms G-37 must be filed with the tax assessor in the taxation district of the claimant.

Also, effective January 1, 2000, Act 70, SLH 1999, allows an exemption for contracting work exported out of Hawaii.

19. Are the sales of tangible personal property and the rendering of services to a contractor who qualifies for the certified housing project exemption subject to the general excise tax?

Yes. The sales of tangible personal property and the rendering of services to a contractor who qualifies for this exemption are subject to the general excise tax UNLESS the supplier or service provider has submitted an approved Form G-37 to the Department of Taxation.

20. If contracting income is exempt from the general excise tax because it is from a certified or approved housing project or a scientific contract with the federal government, may the contractor also claim the subcontract deduction for this same project?

No. As stated in question #16 above, the subcontract deduction cannot be more than the total gross income which would be taxable were it not for this deduction. Since the income from this project is already exempt from the general excise tax, the contractor may not also claim the subcontract deduction.

21. Is it possible for a contractor to have more deductions than income to report on a periodic general excise tax return?

Yes. It is possible to have more deductions than income to report on a periodic return.

EXAMPLE - Champion Construction files a monthly general excise tax return on which it reports \$100,000 of gross contracting income. Because all of this income is from a low-income housing project for which a certified Form G-37 has been submitted to the Department of Taxation, Champion Construction can deduct all \$100,000. Champion Construction also has a \$10,000 bad debt from another contract to be deducted on this return. As a result, Champion Construction has \$100,000 in gross income, and \$110,000 of deductions to report.

22. What happens when there are more deductions than income to report?

If a contractor actually reported more deductions than income on a periodic general excise tax return (as occurred in question #21 where the combined amount of the subcontract and bad debt deductions exceeded the income), a negative taxable income and negative tax liability would result. However, the Department does not consider a negative tax amount reported on a periodic general excise tax return to be a credit to be refunded. A negative tax also cannot be claimed against the tax due on a subsequent periodic return.

Rather than reporting more deductions than can actually be deducted, a contractor should just deduct an amount which is equal to the gross income reported, and carry the balance over to subsequent periodic returns until the deduction is used up. The contractor may not, however, carry deduction amounts over into another tax year. The full amount of any deductions you are eligible to claim during the year should be reported on the annual general excise tax return for the year; a negative tax amount reflected on an annual return will be refunded.

NOTE: See also questions #16 and #20.

23. Must contractors always use the accrual method of accounting for general excise tax purposes?

No. Contractors may use the cash method of accounting for their income and expenses as long as it does not distort their income. However, many contractors, particularly those whose contracts extend over several months or who maintain an inventory of construction materials, will need to use the accrual method. The same accounting method should be used for both general excise and net income tax purposes.

24. How is the income from bonded jobs reported?

When a construction project is bonded, payments are made to the bonding company rather than to the prime contractor for the project. The bonding company will pay the subcontractors, retain any amounts due to it, and pay the remainder to the prime contractor.

In this situation, the bonding company is only considered a custodian of the funds, and will be taxed on its share of the income only. The prime contractor, however, must report as gross income the contract amount, although it may claim any allowable deductions such as the subcontract deduction.

25. If a subcontractor contracts with a prime contractor for an agreed upon amount, and is instead given the materials needed for the job and a check for the difference between the total contracted amount and the cost of the materials, what will the subcontractor have to pay the general excise tax on?

Gross income includes the value of any goods and services received. Therefore, the subcontractor will be subject to the general excise tax on the full contracted amount, and may not exclude the cost of the materials provided by the prime contractor.

26. The federal government sometimes issues contracts known as "cost-plus contracts". What are cost-plus contracts, and how are contractors with these types of contracts taxed for general excise tax purposes?

Federal cost-plus contracts are contracts in which the federal government agrees to reimburse the contractor for the cost of material, plant, or equipment used in the performance of the contract, and to also pay the contractor an additional amount which either may be a fixed fee or a percentage.

Federal cost-plus contractors may exclude from gross income the amount reimbursed for costs incurred for material, plant, or equipment purchased from a seller with a general excise tax license, provided that (1) the reimbursement does not exceed the gross proceeds of sale, and (2) the seller certifies to the department that the seller agrees and elects to report the gross proceeds of sale as a retail sale taxed at the rate of 4%.

Currently, the Department does not have a special form for this purpose. Pending issuance of further guidance and forms for the seller's certificate, the certification requirement may be satisfied by a statement given to the contractor by the seller where the seller agrees and elects to report the sale at the 4% retail rate. The contractor should retain the seller's statement in the event that the contractor is audited.

27. What do contractors have to pay the use tax on, and what are the use tax rates?

The use tax is levied on the landed value of tangible personal property imported into Hawaii from anywhere outside Hawaii. The landed value is the value the item has at the time it arrives in Hawaii, and includes the sales price of the item, shipping and handling fees, insurance costs, customs duty, etc.

The use tax is 0.5% on the value of goods, such as building materials, which a contractor will incorporate into a finished work or project in such a form that it remains perceptible to the senses.

The use tax is 4% on the value of goods, such as tools and equipment, which a contractor will use but not incorporate into a finished work or project.

After December 31, 1999, the value of imported services is also subject to the use tax. If the imported services become identifiable elements of the finished work under the contract, the use tax is 0.5% of the value of the imported services. In all other cases, the value of the imported services is subject to the use tax at the rate of 4%.

28. Is the importation of heavy equipment into Hawaii for use during the term of the contract subject to the use tax?

The importation of heavy equipment into Hawaii for use on a project will be subject to the use tax unless the equipment only will be in the State temporarily. Generally, the importation of equipment for less than 365 days during the year is considered temporary.

29. Where can I find more information on the general excise and use taxes?

The Department has published 2 brochures, "An Introduction to the General Excise Tax", and "An Introduction to the Use Tax", which may be obtained from any district tax office. Also available are 2 previous issues of Tax Facts, Tax Facts Number 95-1, "All About the Hawaii Use Tax", and Tax Facts Number 96-1, "General Excise vs. Sales Tax."

All of these publications also are available on the Department's site on the Internet. Our address is:

<http://www.state.hi.us/tax/tax.html>

30. How long should contractors keep their records for audit purposes?

Generally, contractors should keep records that will enable the Department to verify the accuracy of income and exemptions claimed for a period of 3 years. The subcontract deductions will be disallowed if the records are not sufficient to support the deductions.

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